# DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15428
San Diego, Calif. 92115

36 Letters per Year—$60.00 Annually

Registered with the Securities Exchange Commission

March 20, 1968 Letter 387

"A pathetic commentary on the times is the large quantity of Roman money that went into hoarding, the finding of which has enriched the cabinets of collectors. The hoards secreted towards the end of the third century consist almost solely of copper. In these patina encrusted pieces one reads the frantic uncertainty of the age—the emperor an embezzler, the government a liar, and frightened men clutching at bits of copper as the sole reality in a crumbling world." From Money and Man by Elgin Groseclose.

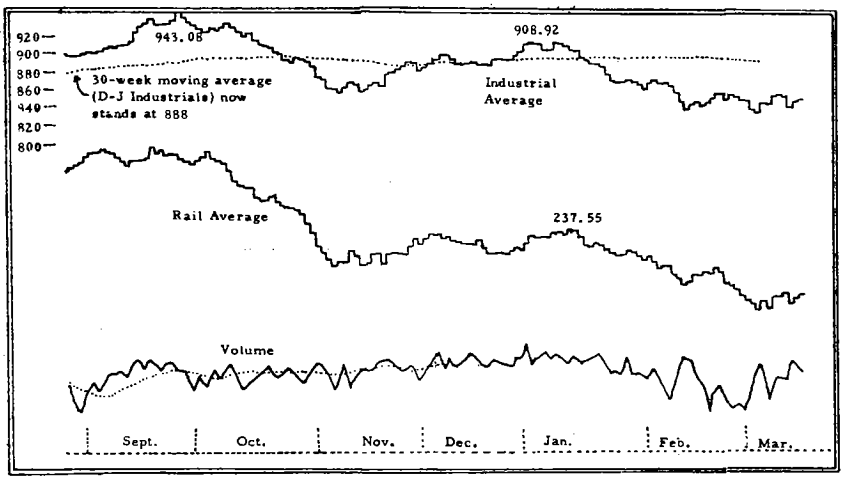
THE PICTURE: This is written Monday morning (March 18), only one day after the Sunday announcement by the seven members of the now defunct Gold Pool. The weekend announcement will require time to be digested, it will require time to be understood and reacted to. From that standpoint, it is difficult to give my views, but at any rate here they are.

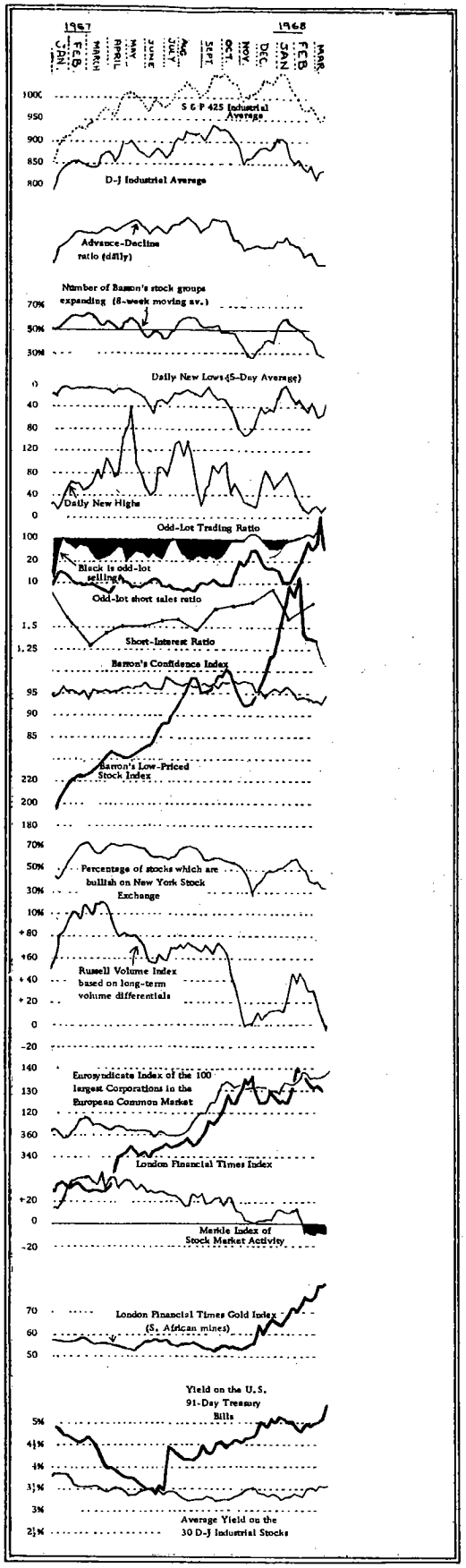
(1) The U.S. boost in the discount rate to 5% was shockingly small. Most observers expected 6% and 6.5%—even 7%. It was the smallest possible boost, and suggests that the U.S. is going to try to "slide by" with the minimal possible action.

(2) It was obvious that the Gold Pool members, in the face of shocking gold losses, laid down definite terms to the U.S. in return for certain agreements on their part. One of the general terms must have been that the U.S. get its balance-of-payments deficit in hand, and fast. This means a big surtax, a sharp cutback in U.S. spending, and a clamping-down by the Federal Reserve on "printing press" activities.

The pace of the Vietnam war is to be increased, and this will bring on further huge expenses. The U.S. is being asked to raise taxes and cut expenses in an election year. I expect that both of these procedures could ultimately turn out to be as half-hearted as the 1/2% boost in the discount rate. The next result should be (as it always is) more whopping deficits in our balance-of-payments, and more pressure on the dollar.

(3) The establishment of the two-market price for gold constitutes admission that the Gold Pool members were unable to halt speculation against the dollar. In effect, the Pool members were saying, "We're not going to lose all our gold reserves in order to hold gold at $35 an ounce. So the best thing is





1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

 to tell the world that we are not interested in more gold. We have all the gold we need now, and we will use our current reserves to settle our own accounts. If you speculators think gold is worth so much, go out and bid the price up yourselves. Gold at over $35 an ounce has no interest for us, and we don't know why you're interested in it if we're not."

(4) The Gold Pool action (forget their thinking) represents an unofficial devaluation of the dollar. It will take time for the world to realize this, but when the Gold Pool disbanded and threw gold on the free market, they were admitting that the free market was insisting that the dollar was worth less than one thirty-fifth of an ounce of gold. This is in effect devaluation in the free, supply-demand market.

(5) South Africa, which produces 75% of the world's new gold, will in all probability now sell all newly mined gold at the highest price, which means selling it on the free market. The London gold market has been closed until April 1, and this means that Paris will assume (at least for two weeks) the status of the leading gold center of the world. It is possible that the Paris gold market will continue to lead, unless there is a decided change in London thinking.

(6) The world will now have to ponder whether a modified gold-exchange standard used by the old Gold Pool members will be able to survive in the face of a two-price gold system. They will have to appraise the true value of the various currencies of the seven nations (which is based on $35 gold), in the face of the true (i.e. free market) value of gold which is above $35 per ounce.

In my opinion, the artificially "pegged" currencies of the seven nations will come under gathering suspicion. It is a question of whether the value of an article (in this case money) is what politicians say it is, or whether the value of an article is what the free market says it is. In the end, I believe the free market will prove correct.

Therefore, I would expect slow pressure on the various "pegged" currencies, increasing suspicion, and then a series of devaluations as the various nations "throw in the sponge" on holding their pegged currencies at the old relationship which is based on a fixed or pegged pre-World War I price for gold.

(7) Finally, I want to note that all this is occurring within the framework of a primary bear market. In a bear market the trend is down, and if this is correct international trade will slowly recede. The pressure will then be on stimulate trade, to try to inflate, and this will place a double pressure on the $35 price of gold. The first pressure, of course, is the concept that water (or gold) tends to seek its own level. Since the supply-demand price of gold is above $35 per ounce, there will be a natural tendency towards leakage of gold reserves among the seven old Gold Pool members. Secondly, there will be the pressure to inflate. The way to inflate is to print more currency against existing or increasing gold reserves.

Since the Gold Pool members will not be getting any new gold supplies (who is going to sell them any gold at $35 per ounce) and will probably be losing gold through leakage, they will have to expand their money supplies via the printing press (i.e., without being able to boost the gold reserves behind their currencies). This will result in increasing suspicion of all paper or partially gold-backed currencies.

CONCLUSION: The new two-priced gold plan is at best a stop-gap measure. It represents the very least the participating nations could have done in the face of the very serious international monetary situation. Suspicion of the various currencies will increase as leakage of their gold reserves starts. The world will realize that the dollar and the pound have already been devalued by the free market (today the Swiss banks fixed the price of gold at between $43 and $45 per ounce), and they will realize this despite the fact that the seven nations have pegged their currencies to an artificial price for gold, a price that the free market does not accept.

There is an old Wall Street adage to the effect that "the first reaction of the market to a shocking or dramatic event is usually wrong." The gold stocks are now correcting and the general market is rallying. Although a big gold correction is overdue, and although a good market rally is overdue, I believe that in time the golds will move higher and the market will fall under pressure of the prevailing primary bear trend. It takes time to digest and properly discount events of major proportions. It will take time now, but I again remind readers that the second phase of a bear market is almost always deceptive (and in the end costly). This second phase will be no different.

THE MARKET: A bull market started on June 13, 1949 at 161.60 on the Dow Industrial Average. By mid-February, 1966, sixteen and one-half years later, the Dow had climbed to 995.15. This represented an advance of 833.55 points for an increase of over 500%. The great bull market was accompanied by rising corporate profits, a boom psychology, speculative fever at the highs, vast social changes, astronomical increases in government spending, periodic wars and galloping inflation.

In the course of this longest bull market in recorded history, a price was paid. That price was the integrity of the currency of the U.S. The dollar is defined roughly as a value-unit equal to one thirty-fifth of an ounce of gold. For decades the dollar was considered "as good as gold," and there was no question but that at any time dollars could be exchanged for the real value behind the dollar— gold. Then the first major change took place, and U.S. citizens were forbidden to exchange their dollars for gold. As of March 17, 1968, the second major change occurred. Foreigners (except for Central Banks who "cooperate" in the new scheme of things) are forbidden to buy U.S. gold. Thus, in effect, we have embargoed our gold to the citizens of the world. The dollar is no longer as good as gold. It is worth less than the pegged U.S. price for gold, and even at that pegged price if you are a dollar-holder in France, Belgium, Egypt, or Zambia you can not turn in your dollars for gold. Thus, the value of the dollar has become one of the biggest question markets in the world today.

To get back to the stock market, we began the market section by talking about a sixteen and one-half year bull market. Robert Rhea, the great Dow Theorist of the 1930's, estimated that most primary bear markets last about one-third to half as long as their preceding bull market. If this is true it follows that we can expect a bear market of around five years or longer. Since the bear market began in February, 1966 (two years ago), we might conclude that the bear has about three more years to run. At any rate, that would be my guess.

It is of interest that 1967 was a selling year for the odd-lot public. This probably meant (in a general sense) that professional speculators were buying stocks for the rise while a sceptical public was selling. Now 1968 has produced a startling change. The odd-lot public is buying stocks quite heavily (see odd-lot balance ratio on page 1), and the investors, speculators and professionals are selling. This means we are in a distribution area with shares being distributed to the public.

It would not surprise me to see the public taking in shares for the better part of the remainder of this bear market. It takes the public a long time to change its mind, and just as it took from 1949 to approximately 1960 to turn the public rampantly bullish regarding the bull market (which was 11 years old in 1960), it could take 3 or 4 years to turn that same public dead bearish on the bear market (which is now only 2 years old). At any rate, here we are with the Dow still unable to better its top of 2 years ago, and the odd-lot public is buying away.

I want to state that this type of activity is not unexpected during the second phase of a bear market. Subscribers will remember that I have often warned that the second phase is almost always the longest and most deceptive phase. I consider the second phase to be the "transition" period, wherein many bullish and bearish factors are still intermixed and confused. The public is sensitive to every new development, every rumor, every hopeful suggestion that maybe the highs of 1966 will yet be approached and then surpassed.

Right now it is obvious that a great many people still do not see or understand that the tide is slowly running out. They still expect the Government to press the right buttons; they still expect everything to somehow "right itself," thereby propelling their stocks to the old highs and turn their current losses into profits. They do not understand that the Dow Theory is working in the same relentless fashion in which it has always worked. And that despite temporary (but hopeful) rallies, despite occasional bursts of cheerful news, the market two years ago ( in 1966) discounted the best that could be seen ahead. But February, 1966, has now passed and the bull market has breathed its last. The bear has now taken over Wall Street, and its grip is tightening with every passing month. We must temember that during a bear market the fundamentals are exactly opposite those which held sway during the bull market. During a bear market we can expect the Averages to probe sporadically lower until the market has fully discounted the worst that can be seen ahead.

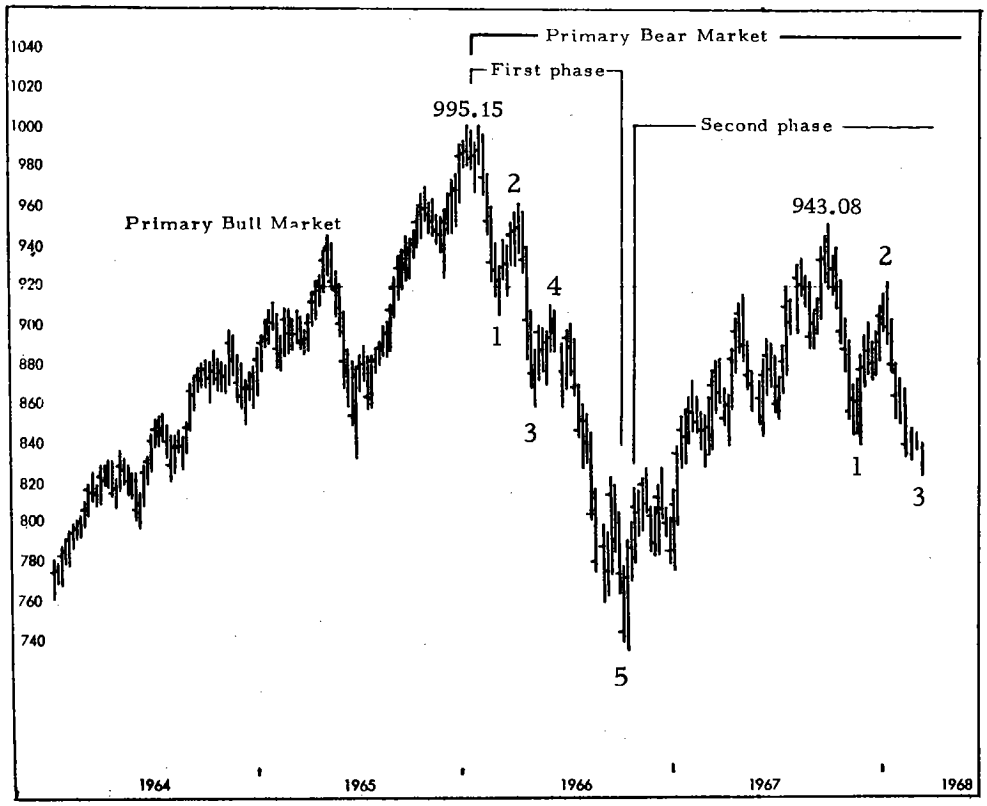
Sometimes the simplest statements are the hardest to comprehend. Therefore, I wonder if my subscribers understand fully what I mean when I repeat that "bear markets are meant to separate stockholders from their money." Perhaps I can illustrate that fundamental statement with the following comment from the March 8 Christian Science Monitor. This little news clip, I thought, was both tragic and informative.

> But if individual investors are discouraged at seeing their portfolios melt, consider the plight of mutual-fund managers who must watch over portfolios ranging up to a billion dollars or more—and who must answer to their shareholders for their mistakes.
>
> Since the beginning of the year, the Dow-Jones Industrial Average—the not-too-accurate but widely used indicator of market movements—had fallen 74.55 points (8.2 percent) from its close on Dec. 29, 1967.
>
> **Mutual funds plummet**
>
> By contrast, mutual-fund prices have gone down two and three times as far in the same period. For some examples, Enterprise Fund, the most successful of all funds in 1967. has lost more than 15 percent of its price, after adjustment for a stock split earlier this year. Fletcher Fund, operated by the same management as Enterprise and itself the second-best-performing fund last year, lost 25.3 percent up to the start of this week.
>
> Widely followed Manhattan Fund is down 23.2 percent and, in fact, was trading early this week at a price well below its original offering price of February, 1966. Dreyfus Fund, with assets of more than $2 billion, had lost 15.1 percent, Fidelity Trend Fund was down 15.7 percent, the speculative Keystone S-4 was off 20 percent, and Fidelity Capital Fund was down 8.7 percent, or just slightly more than the Dow.

Now here is another comment regarding bear markets which I want to present. During bear markets it is "normal" for prices to start the new year near their highs and end the year near the lows. This is because bear markets work through time, and because values during a bear market continually depreciate. Thus, we see that during 1966 the high for the year was set in February, the low in October. During 1967 a high of 909.63 was recorded early (in May), and although the Dow pushed up again to a new high of 943.08 (September) by December the Dow had fallen to a low of 849.57. During 1968 the high for the year was seen in January, and, of course, we have not had the story on the low yet. But I would guess that this year will end with substantially lower prices than we see now. I will repeat again, time (during a primary bear market) works against values. In other words, the "things"

which you own now in March, 1968, will probably be worth less at the end of 1968. They will probably be worth still less towards the end of 1969 or whenever the bear market ends. Discounting temporary rallies, the stock market should reflect this phenomenon.

PHASES AND PATTERNS: I have written a good deal about the three psychological stages of a bear market. As shown on the chart, I believe the first phase of the bear market took place between Feb. and Oct., 1966. The first phase (in which the bloom, classically, is taken off the speculative rose) erased 251 points from the D-J Industrial Average.



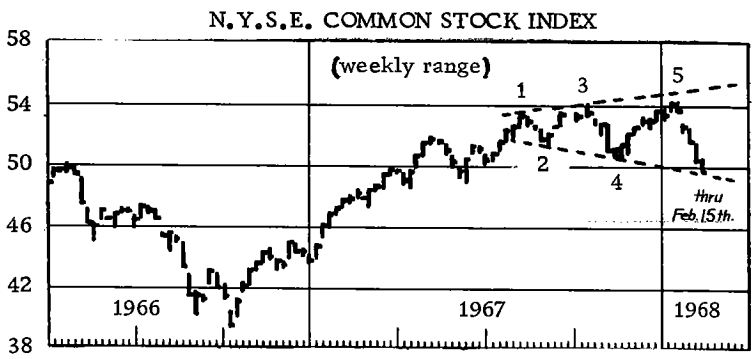

The second phase is classically the phase in which stocks ultimately discount a general and increasingly obvious deterioration in the earnings and outlook for stocks and business. The second phase of this bear market began in October, 1966, and it opened with a remarkable and most speculative rally. The rally topped out in September, 1967 at 943.08. From then on the downward portion of the second phase was underway.

I have often referred to the Elliot Wave Theory. This is the theory which holds that all markets occur in five waves. Three waves in the direction of the main trend and two waves counter to the main trend. Although Elliot considered his five-wave thesis to be an immutable rule, I would prefer shying away from any fixed rules as applied to the stock market. Nevertheless, the five-wave pattern does repeat so often in stock market movements that it is worth taking up at this time.

Note that the first phase of the bear market was completed in five definite waves. I have numbered these five waves on the chart. The fifth wave ended at the 744.32 low of October, 1966. The resultant correction to the 1967 high took the form of a very complicated three wave correction and extension.

Now note that I have drawn the movement down from the 943.08 1967 high in the form of 3 distinct waves. So far, as I count them, we have completed wave 1, wave 2 and probably much or all of wave 3. Wave 4 which could now be in progress will probably be a sort of consolidation wave much as was wave 4 during the year 1966. Then, if Elliot has any validity, we can expect to go into final wave 5. I believe wave 5 will carry below the terminal of the 1966 wave— or below 744.32

EXTRAORDINARY FORMATION: In studying the weekly pattern of the highly-touted N.Y.S.E. Common Stock Index, I note a rare and interesting formation. This is the broadening top, a pattern familiar to all veteran readers of these Letters.




The broadening formation is a series of five movements, each successive rally carrying above the preceding decline low. The broadening formation is almost always a distributive formation, and it is completed when the price action (following point 5) carries below the lower trendline (the trendline on the chart which connects points 2 and 4).

Basically, the broadening formation is a picture of price action which is "out of control." It occurs very occassionally in extremely speculative markets, and it is caused by the market whipping first one way, then the other in almost frenzied series of reversals.

As far as I know, the only completed broadening pattern previously to appear in an average was the broadening top (see illustration and discussion in the book, Technical Analysis of Stock Trends, by Edwards and Magee) during the summer of 1957, just prior to the July-October collapse.

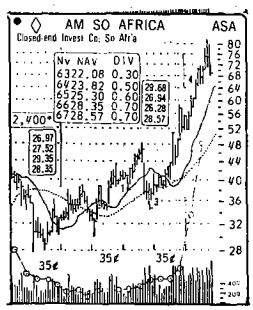
It appears to me that the current broadening formation in the N.Y.S.E. Index would be completed by a drop to approximately 47.5. If completed, we will have seen one of the rarest and most remarkable tops ever to appear in any Average, and I thought subscribers would find this phenomenon of particular interest.

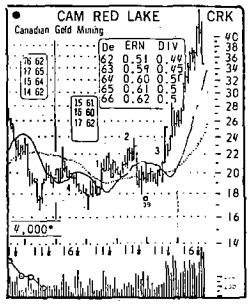
This analysis seems clear enough and logical enough. Nevertheless, I want to warn readers that I have presented an obviously theoretical analysis, a pattern which the market may follow if it wants to be obliging and confirm my "logic." But Wall Street is a difficult and treacherous place, and there is nothing which says that the Averages have to render Richard Russell correct. With that warning, I present this study for what it is worth. I find it interesting.

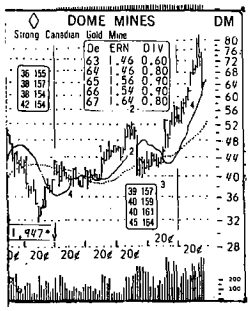
I might add that if wave 4 and wave 5 are completed, we can then expect a more important correction and then a final series of 5 waves down to the bottom of this bear market. Those last 5 waves should complete the bear market and lay the base for the next major primary bull tide.

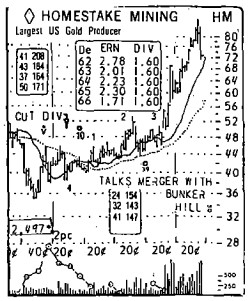
---

# DOW THEORY MARKET LABORATORY PAGE



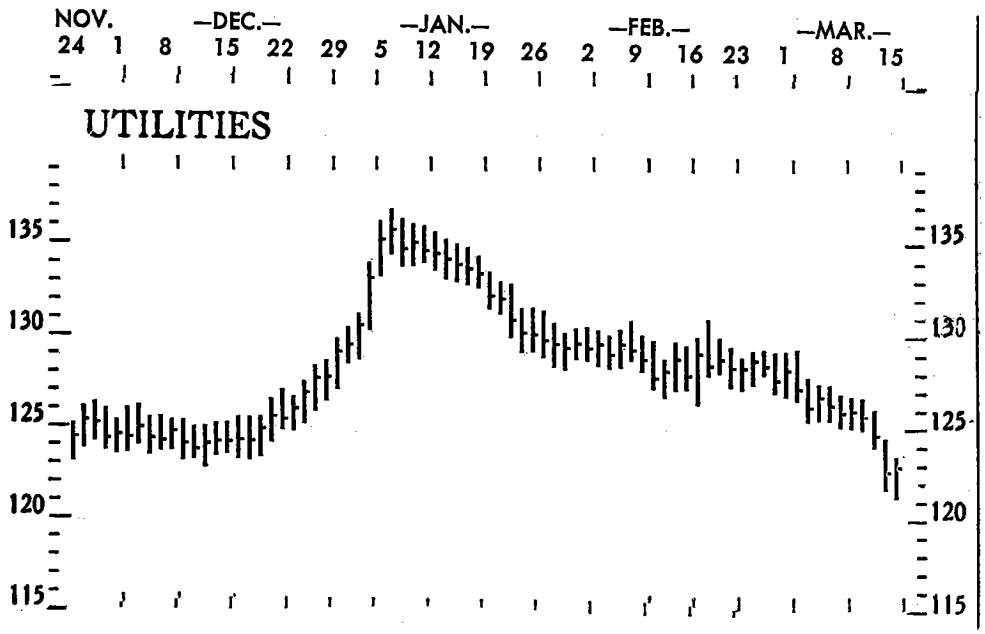

GOLD SHARES: I have included weekly charts (courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas). These charts show a great many things, not the least of which is the 200-day moving average on each stock (this is the fine dotted line).

It is obvious that the gold shares are now in the throes of a severe correction of their recent violent "blow-offs." In such cases, as I have written before, it is normal that ultimately the correction will take each share back to the vicinity of its 200-day moving average. From there, if the trend is still bullish, there should be a consolidation (often a long one), following which the major upward movement may be started again.

As seen on these charts, the 200-day moving average for American-South African is approximately 51 1/2, the moving average for Campbell is 25 1/2, for Dome 53 and for Homestake 58. As each stock approaches its long-term moving average the decline should grow "sticky," and a series of up and down movements may then take place.

Just as all the analysts during the last month or so were pointing to the gold shares as the buys of the century, they are now telling you that they were overpriced, and even those who were bullish on golds are saying that you should sell half of your holdings if they break such and such a level.

As I have said before, the gold shares are extremely tricky to trade, they are subject to spot news, and their movements are very difficult to predict on a charting basis. I would prefer holding the golds as we have all along on the basis of the fundamentals and as a hedge against the greed and immorality of politicians. Many speculators were caught at or near the top of the recent gold movement, and they are now taking their losses, thus giving violence to the downmove. As a hedge against monetary disorders, however, the golds still have no peers, and I continue to recommend retention of our 10% to 20% hedge positions.




UTILITIES: In the past I have presented a number of studies of the Utilities as a leading stock market indicator. Over and over again a persistent trend in the Utility Average has presaged important movements in the market. Obviously, the Utilities, whose steady dividends are compared with bond yields by many investors, are now discounting the possibility of a new credit crunch, tightening money, and very high yields on bonds.

Note on the daily chart from the Wall Street Journal that the D-J Utility Average is now at a new low for 1968, closing just above the 122 level. This is a bearish omen. The points to watch now are the 120.97 low of 1967 and the 118.96 low of 1966. If Utilities break the 1966 low (which is 3 points under today's level) they will have cracked to their lowest level since 1962. Therefore, I consider today's new low for 1968 bearish, and I would consider a breaking of the 1966 low of 118.96 as ominous indeed for the market.

LATE NOTE: Yesterday (March 18) The Dow opened up over 13 points on the news of the new gold program. I wrote earlier in this Letter thaht the market's first reaction to dramatic news is often the wrong one. By the close March 18 the Dow was up only 2.51. Today (March 19) the Dow is off 2.50 at noon as I close this Letter. But as of this writing the Dow has erased the entire March 18 celebration rally regarding the new gold program. From here on, things could get interesting.